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“Fine Distinctions” in the Contemporary Law of Insider Trading

Donald C. Langevoort^{*}

Fifty years after *Cady Roberts*’ claim that the law of insider trading should never be circumscribed “by fine distinctions and rigid classifications,”¹ that body of law is still mutating. To be sure, we now have a stable framework of three distinct legal theories—the classical theory, the misappropriation theory, and Rule 14e-3—each of which is well understood as to its basic elements.² Most insider trading cases handed down in any given year say nothing particularly new about the state of the law, but rather simply apply familiar principles to sometimes challenging facts.³ But every so often we do discover something new, and in the process, about the core conception(s) of insider trading.

Though I want to concentrate mainly on this contemporary case law in this essay, doctrinal history is an essential starting point.⁴ By all accounts, Chairman Cary wanted a wide scope to Rule 10b-5 that took in fiduciary breach (constructive fraud) as well as classical common law deceit to help build a federal body of corporate law that would supplement, if not

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¹ In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961)

² See DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION chs. 3, 6, 7 (2012 ed.).

³ Materiality questions tend to be the hardest, but the courts—both in insider trading cases and fraud cases generally under Rule 10b-5—have by and large resisted any efforts to take cases away from the fact-finder, who is expected to apply a highly general standard of what a reasonable investor would likely consider important. Id. ch. 5. For a criticism of this approach, see Joan Heminway, *Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading*, 72 La. L. Rev. 999 (2012).

⁴ See Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 Geo. L.J. 1083 (1985).

supplant, the meager efforts of state courts and legislatures.⁵ He thought it unnecessary to answer the hard questions posed by common law courts that had struggled with how open-market purchases or sales become deceptive simply because the trader had an informational advantage resulting from some privileged position of access,⁶ because federal corporation law should be more ambitious than that. Cary's expansive impulse, however, thrived only for a while, and within twenty years its premise—that there is a free-floating federal fiduciary obligation discoverable within Rule 10b-5—was soundly rejected as a matter of principle. In celebration of the perceived virtues of state-law primacy that Cary instead found so disturbing, the Supreme Court said that fraud under Rule 10b-5 means real deception, nothing less.⁷

That left insider trading law in an awkward place, because no one has ever been able to articulate a robust theory of harmful marketplace deception arising from insider trading. The insider's order is anonymous, communicating nothing except the fact of a trade, inducing no one else to take the other side except as an independent choice to offer liquidity. So where is the detrimental reliance? On whom, or what? There may be very

⁵ 40 S.E.C. at 910. Cary later offered useful commentary on this own thinking. See William Cary et al., *Insider Trading in Stocks*, 21 Bus. Law. 1009 (1965). While this is generally viewed as the driving force behind the duty to abstain or disclose, the more specific history of concern at the SEC about brokerage firms using inside information to compete for customer favor and order flow at a time of fixed commissions is also worth noting. See Stanislav Dolgoplov, *Insider Trading, Chinese Walls and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, 4 J. L. Econ. & Pol'y 311 (2008). Dolgoplov points to evidence that the SEC staff in the New York regional office had determined to charge Cady Roberts and its involved partners with a 10b-5 violation for insider trading before Cary came to the Commission, so that although credit for the articulation (and justification) of this novel use of 10b-5 goes to Cary, it was the staff that initially formulated the argument. *Id.* at 339.

⁶ See *Goodwin v. Aggasiz*, 186 N.E. 659 (1933). This difficulty in *Cady Roberts* was stressed early on in William Painter, *Insider Information: Growing Pains for the Development of Federal Corporation Law under Rule 10b-5*, 65 Colum. L. Rev. 1361, 1381 (1965).

⁷ *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977). For my commentary on the limited success of *Santa Fe* in moving fiduciary duty off the center of the federal stage, see Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 Wash. U.L.Q. 449 (2001).

good economic policy arguments to prohibit it anyway (though these are still highly contested⁸), but preventing open-market deception is not the fundamental point of any of them.

So how or why did the insider trading prohibition survive the retrenchment that happened to so many other elements of Rule 10b-5? The Supreme Court's decision in *Chiarella v. United States*⁹ in 1980 cut back on the law's scope, but still sustained the useful fiction of insider trading as actionable deception. The core of insider trading regulation was left standing. We might call this a fictional "Cary-Powell compromise," because Justice Powell was the moving intellectual force on the Court in reconceptualizing insider trading¹⁰ and cited *Cady Roberts* repeatedly and with apparent favor in both *Chiarella* and its follow-on, *Dirks v. SEC*,¹¹ even as he was otherwise doing so much pruning. Powell's two opinions joined with Cary in promoting the fiduciary's duty of affirmative disclosure as the crucial explanation for how insider trading can be thought to be deceptive, without mention of the lingering irony of depending so much on purely constructive fraud.¹² The later-developing misappropriation theory, a significant modification to the compromise that the Court finally ratified in 1997, long after Justice Powell had retired,¹³ was even more

⁸ I leave to elsewhere the never-ending debate among both lawyers and economists about whether and why insider trading is good or bad for the stock markets, stimulated initially by the work of Henry Manne. For a recent collection of citations to this literature, see Stephen Clark, *Insider Trading and Financial Economics: Where Do We Go From Here?*, 14 Stan. J. L. Bus. & Fin. 43 (2010); see also LANGEVOORT, *supra*, §§1:2-1:6.

⁹ 445 U.S. 222 (1980).

¹⁰ On Powell's thinking here, drawn from his private papers and other sources, see Adam C. Pritchard, Jr., *Justice Lewis F. Powell Jr. and the Counterrevolution in the Federal Securities Laws*, 52 Duke L.J. 843, 931-34 (2003). The fiduciary emphasis reflected Powell's deep-seated respect for fiduciary obligation, coupled with the idea that using this, rather than some more expansive line of demarcation, would dissuade the SEC and prosecutors from pursuing a parity of information campaign.

¹¹ 463 U.S. 646 (1983).

¹² See Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Cal. L. Rev. 1 (1982).

¹³ *United States v. O'Hagan*, 521 U.S. 642 (1997). On Justice Powell's apparent rejection of the misappropriation theory, see Adam C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. Rev. 13 (1998); Pritchard, *supra*. Although the Supreme Court did not endorse the theory until

accommodating in accepting fiduciary faithlessness as deception, pushing the law back more in Cary's direction. As I argued in an earlier essay on *Cady Roberts*, this strange and intellectually ungainly judicial commitment to assertive insider trading regulation, even by some fairly conservative judges, shows how powerful a totemic symbol the prohibition of insider trading has become in "branding" the American securities markets as supposedly open and fair, and American securities regulation as the investors' champion.¹⁴ Insider trading regulation had already taken on an expressive value far beyond its economic importance, which judges were reluctant to undercut.¹⁵

This commitment is hardly unconditional, however. From the beginning, Wall Street has tried to label the SEC's campaign against insider trading as an unrealistic and ill-conceived effort to achieve "parity of information" in securities markets, taking away the incentive to information discovery crucial to market efficiency. That was always a bit of hyperbole—from *Cady Roberts* on, the effort was always to define a category describing the illegitimate use of confidential information separate and distinct from proper uses. But legitimacy is in the eyes of the beholder, and it is possible to think that it is never fair to take advantage of secrets that belong to others without their clear-cut permission. If that drives the enforcement philosophy, we edge closer to parity of information, even if we never reach it.¹⁶ *Chiarella* chose the fiduciary principle as a line of

1997, the Second Circuit had embraced it almost immediately after *Chiarella*; outside the Second Circuit the theory was received unevenly, with adherence in some other circuits but rejection elsewhere. See LANGEVOORT, *supra*, §6:2.

¹⁴ Donald C. Langevoort, *Re-reading Cady Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 Colum. L. Rev. 1319 (1999).

¹⁵ The courts' tolerance was no doubt also bolstered by the fact that, earlier case law notwithstanding, novel insider trading cases are almost always posed in SEC enforcement actions or criminal prosecutions, not in the private securities class actions in which so many judges seem to have lost faith. See LANGEVOORT, *supra*, at §9:1. It is difficult to predict how insider trading law would have fared had the first case to come up to the Supreme Court been one of whether and how much other investors could recover in class action suits claiming open market insider trading.

¹⁶ See Arthur Fleischer et al., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798 (1973). The classic quest to define the illegitimate use

demarcation here based on the idea that it was naturally wrongful for fiduciaries (or their confederates) to secretly enrich themselves.

My argument is that the Supreme Court embraced the continuing existence of the “abstain or disclose” rule, and tolerated constructive fraud notwithstanding its new-found commitment to federalism, because it accepted the central premise on which the expressive function of insider trading regulation is based: manifestations of greed and lack of self-restraint among the privileged, especially fiduciaries or those closely related to fiduciaries, threaten to undermine the official identity of the public markets as open and fair. The law thus grants an entitlement to public traders that marketplace pool will not be polluted by those kinds of insiders. But enough time may have passed that we may have lost sight of the compromise associated with this fiction and started acting as if insider trading really is the worst kind of deceit. The result is pressure on doctrine to expand, using anything plausible in the 10b-5 toolkit.

Others have noted this expansionism, too; Donna Nagy has described it as the gradual “demise” of fiduciary principles in the law of insider trading.¹⁷ My aim here is to tie the concern more clearly to the uneasy deceptiveness of insider trading, first using somewhat familiar examples such as the debate over whether possession or use is required for liability (Part I) and the supposed overreach of Rule 10b5-2 (Part II). Each of these settings brings us back to the centrality of intent, reminding us that the Cary-Powell compromise has in mind a form of intentionality that is closely tied to greed and opportunism, making insider trading a sui generis form of securities fraud.¹⁸ That takes us to the most jarring recent development in insider trading law, the emergence of recklessness as an alternative basis for liability (Part III). I finish with consideration of insider trading without a fiduciary breach (Part IV), and a brief conclusion.

of inside information was Victor Brudney, *Insiders, Outsiders and Informational Advantages under the Federal Securities Laws*, 93 Harv. L. Rev. 322 (1979).

¹⁷ Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 Iowa L. Rev. 1315 (2009).

¹⁸ See also Samuel W. Buell, *What Is Securities Fraud?*, 61 Duke L.J. 511, 561-63 (2011).

I. SCIENTER AND INSIDER TRADING

We know from historical research that when Congress gave the SEC rulemaking authority in Section 10(b) in 1934, it did not intend to spawn the expansive and doctrinally intricate antifraud prohibition that later emerged.¹⁹ The Commission accomplished the first round of invention in 1942 by transforming Section 17(a) of the Securities Act into Rule 10b-5, a prohibition fit for fraudulent purchases and sales, which the courts then busily fashioned over the next few decades into a deep body of law to promote truth-telling in the securities markets, for the protection of those injured by falsity.

Nothing in the apparent intent of Congress or the generalized desire to pursue “truth in securities” limits the scope of Section 10(b) to deliberate falsity. Negligent misrepresentation was an established tort in the common law, and Section 17(a) has long been read to give the SEC the ability to reach careless deception.²⁰ So for a while—in the decade when Cary wrote *Cady Roberts*—the law under Rule 10b-5 was trending in the same direction based on this and other bold moves: a duty of candor owed by all persons, including secondary actors, that could potentially give rise to liability to everyone in the investment marketplace, whether trading or not.²¹ It was a largely unconfined federal securities tort law, heavily enforced through an implied cause of action that Congress almost certainly did not anticipate,²² much less authorize. The judicial retrenchment of the 1970’s was a reaction to this, with issues viewed through a more conservative lens that found judicial creativity in pursuing corrective justice or other policy aims increasingly distasteful. The Supreme Court’s

¹⁹ See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385 (1990).

²⁰ See *Aaron v. SEC*, 446 U.S. 680 (1980).

²¹ See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

²² See Thel, *supra*.

Hochfelder decision, one of the first in this series, limited Rule 10b-5 to intentional fraud.²³ It did so by finding intentionality implicit in Congress stress on words like “device” or “contrivance” in its grant of rulemaking authority. That was not a necessary or inevitable inference however, and probably wrong in terms of actual legislative intent.²⁴ But it did restrain Rule 10b-5, and everything we know about the Court’s decision suggests that the justices were looking to refashion the Rule’s reach in response to strong claims of excess, especially in private litigation.

So what does scienter mean in Rule 10b-5 litigation? It encompasses falsity where the maker *knows* that what he is saying is materially untrue and has the propensity to mislead. Those are the easy cases. There are two harder sets of issues, however. By far the more familiar one is whether recklessness also satisfies the scienter requirement. Although the Supreme Court, from *Hochfelder* on, has explicitly avoided deciding the question, lower courts say yes. But they diverge quite noticeably when it comes to explaining precisely what recklessness is.²⁵ Some speak in terms of an extreme departure from ordinary care (negligence plus).²⁶ Others—probably the current majority approach—take this same starting point and then add an extra element of subjective awareness, a danger of misleading so obvious that the speaker must have been aware of it.²⁷ This tries to capture the situation akin to conscious avoidance or indifference: the speaker knows that he does not know the truth, but speaks as if he did. That he was not *sure* that he was lying is no defense. As we shall see when we turn specifically to insider trading, there can be significant differences in coverage depending on which articulation

²³ Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

²⁴ See Thel, *supra*.

²⁵ See Buell, *supra*.

²⁶ See SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998).

²⁷ See Gebhart v. SEC, 595 F.3d 1094 (9th Cir. 2010)(discussing case law and holding that subjective recklessness is required, though acknowledging that it can be established through circumstantial objective evidence). See generally Ann Morales Olazabal, *Defining Recklessness: A Doctrinal Approach to Deterrence of Open Market Securities Fraud*, 2010 Wisc. L. Rev. 1415 (2010); for a state law survey of the same problem, see Geoffrey Rapp, *The Wreckage of Recklessness*, 86 Wash. U. L. Rev. 111 (2008).

is chosen. This is not insignificant, because human psychology tends to buffer the awareness of wrongdoing, especially in stressful situations.²⁸

A less noticed but far from trivial issue involves the distinction between motive and intent. Is it relevant whether the speaker desired to mislead investors, or had the purpose of misleading them, so that falsity that is simply collateral damage from a false communication uttered for some other reason is not actionable? The conventional answer is no—awareness of the falsity and its propensity to mislead is enough.²⁹ What, if anything, the defendant was trying to gain from the falsity is unimportant. Indeed, it is hard to justify allowing recklessness to satisfy the scienter requirement if the prohibition is limited to desired deception. But one can find 10b-5 cases that suggest otherwise.³⁰

So is all this a useful template for addressing scienter in the law of insider trading? To the extent that the act of insider trading is not misleading to investors, formulations that stress awareness of the likelihood or risk of misleading investors are plainly inapposite. Yet this is precisely the road taken by many courts. The most challenging problems here relate to tipping (where, as was the case in *Cady Roberts*, the insider passes on the information directly or indirectly to another person who trades), and we will address this in some depth in Part III. Outside of tipping, the context in which this arises involves the distinction between “possession” and “use” of inside information.³¹ Does the plaintiff in an insider trading case (e.g., the

²⁸ See Donald C. Langevoort, *What Were They Thinking?: State of Mind and Insider Trading*, in RESEARCH HANDBOOK ON INSIDER TRADING (S. Bainbridge, ed., forthcoming 2013). For a judge’s thoughts on the motivations for an insider trading defendant for whom he did not want to impose an overly severe sentence, see *United States v. Gupta*, 2012 WL 5246919 (S.D.N.Y. 2012)(Rakoff, J.) (“So why did Mr. Gupta do it?”).

²⁹ See *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202 (2d Cir. 2000); JAMES D. COX ET AL., *SECURITIES REGULATION: CASE AND MATERIALS* 672-73 (6th ed. 2009).

³⁰ Somewhat famously, see *United States v. Stewart*, 305 F. Supp.2d 368 (S.D.N.Y. 2004); Joan Heminway, *Should Martha Stewart’s 10b-5 Charge Have Gone to the Jury?*, in *MARTHA STEWART’S LEGAL TROUBLES* (J. Heminway, ed., 2007), at 203, 211.

³¹ See LANGEVOORT, *supra*, at §3:13. This has been an issue wherever an insider trading prohibition exists. See Hui Huang, *The Insider Trading Possession versus Use Debate: An International Analysis*, 34 Sec. Reg. L.J. 130 (2006); Katja Langenbucher, *The “Use or*

SEC or a criminal prosecutor) have to prove that the insider was motivated to trade by the secret, so as to establish causation? What if the defendant argues that the trade would have occurred regardless of whether he possessed the secret or not? The possession approach simplifies prosecution, and is thus favored by the SEC. In fact, the SEC defined insider trading in terms of simple awareness (not causation) in an interpretive rule adopted in 2000, Rule 10b5-1. This approach connects well to the general understanding of scienter under 10b-5 that we have just described, which stresses subjective awareness but not motivation, as well as how we commonly think about fiduciary responsibility.³²

A number of courts, however, have balked at this in insider trading cases. Prior to the adoption of 10b5-1, some courts in both civil and criminal cases held that the test was based on use, although possession might create a rebuttable presumption of use.³³ Defendants were free to break the causal link if they could persuade the fact-finder. So one could argue that there was other information that led the trader to buy or sell, so that the inside information added nothing to the total mix. Or the need to sell because of financial exigencies would have led to the sale whether or not the trader had come into possession of the information. In fact, this line of case law developed strongly enough that some courts have ignored the adoption of Rule 10b5-1 and continue even today to make causation an element of the cause of action, or at least the subject of an affirmative defense.³⁴

Possession” Debate Revisited—Spector Photo Group and Insider Trading in Europe, 5 Cap. Mkt. L.J. 452 (2010).

³² See SEC v. Capital Gains Res. Bureau Inc., 375 U.S. 180 (1963).

³³ The best known of these are SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) and United States v. Smith, 155 F.3d 1051 (9th Cir. 1998). The Second Circuit, on the other hand, had previously staked out a possession standard in United States v. Teicher, 987 F.2d 112 (2d Cir. 1993), and consistently has adhered to that position. See United States v. Royer, 549 F.3d 886 (2d Cir. 2008).

³⁴ E.g., United States v. Nacchio, 519 F.3d 1140 (10th Cir. 2008), aff’d in part, rev’d in part, 555 F.3d 1244 (10th Cir. 2009)(en banc); SEC v. Talbot, 430 F.Supp.2d 1044 (C.D. Cal. 2006), rev’d on other grounds, 530 F.3d 1085 (9th Cir. 2008). For other citations, see LANGEVOORT, supra, §3:14 n. 2. One court has even characterized the rule as if it had codified *Adler*, which is simply not so. SEC v. Lipson, 278 F.3d 656 (7th Cir. 2002). Once

As a practical matter, this may not be of immense significance; the SEC and criminal prosecutors tend to win their cases even when courts impose the higher burden of proof or permit rebuttal.³⁵ But it is conceptually challenging, and taps into the theme I stated at the outset of this essay. While possession (or awareness) is more plaintiff-friendly and fits most literally with 10b-5 jurisprudence generally, “use” ties much more closely with our intuitive understanding of what insider trading is, and why it is wrongful enough to look away from its questionable deceptiveness. It is about violating an expectation of faithfulness, exploiting privileged access, taking advantage of others. Those are active verbs connoting deliberation beyond mere awareness, and bad faith.³⁶ Connecting back to the expressive function of insider trading regulation, it reflects the belief that insider trading is a manifestation of greed on the part of the privileged, rather than the self-restraint we want from insiders—i.e., the Cary-Powell compromise.

My argument is that to the courts that have demanded a showing of misuse and balked at Rule 10b5-1, there is an intuition that insider trading law is indeed *sui generis*. It isn’t really fraud, even though we’ve chosen to call it that in order to preserve and embellish the useful message of investor protection. If so, then the meaning of insider trading shouldn’t be fleshed out by reference to 10b-5 interpretive principles generally. What’s more, the SEC should not have the unilateral authority to redefine what insider trading means in a way that breaks the Cary-Powell compromise or its 1997 amendment.³⁷ The Court allowed Cary’s constructive fraud to survive via

again courts in the Second Circuit differ, willingly embracing 10b5-1. See *United States v. Royer*, *supra*.

³⁵ See, e.g., *SEC v. Adler*, *supra*; *SEC v. Talbot*, *supra*.

³⁶ Donna Nagy makes a similar point by reference to the policies underlying the insider trading prohibition, but concludes that in doing so the “use” courts are ignoring the basic fiduciary duty principles on which the *Chiarella/Dirks* formulation rests. Nagy, *supra*, at 1350-52. My point is that the fiduciary duty formulation was never meant to import all of fiduciary duty law into the insider trading framework, but instead represents a way of brightening the line between legitimate and illegitimate uses of inside information. If so, the “use” courts are actually being more faithful to the bargain.

³⁷ This has led to claims that the SEC has exceeded its authority in adopting the rule. See Allan Horwich, *The Origin, Application, Validity and Potential Misuse of Rule 10b5-1*, 62

the fiduciary principle, and the nature of the bargain is that the judiciary retains control over the scope of the law so as not to allow that scope to expand beyond the reasons for its acceptance. To me, this helps explain why in the two earliest foundational Supreme Court cases of contemporary insider trading law, *Chiarella* and *Dirks*, the Court gave no *Chevron*-style deference to the SEC's interpretation of insider trading law under its own rule or its statutory grant of rulemaking authority,³⁸ and why Rule 10b5-1's definition has had such surprisingly little bite.

II. THE MEANING OF MISAPPROPRIATION

The misappropriation theory of liability for insider trading rests on the idea of secretive fiduciary disloyalty. The insider deceives the source of the information, who has entrusted it to the insider with the expectation that he would act as a loyal fiduciary and not take personal advantage of it, by “feigning” loyalty while acting selfishly. In contrast to the classical approach articulated in *Chiarella* and *Dirks*, the misappropriation test has at least a plausible theory of deception given its fact-to-face nature: presumably those who entrust information in a fiduciary setting to another actually do expect fidelity and are feel that they have relied to their detriment when the trust turns out to have been misplaced.³⁹ But this is still

Bus. Law. 913 (2007); see also Carol Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scierter*, 52 U. Kan. L. Rev. 147 (2003).

³⁸ This was remarked on recently by the Court in *Janus Capital Group Inc. v. First Derivative Traders*, 131 S.Ct. 2296, 2303 n.8 (2011). Formally, the reason for not following the SEC's interpretation in *Chiarella* and *Dirks* was that the Commission did not have the ability to exceed its statutory mandate, which is limited to that which is fraudulent. That is of course right, but question begging if we acknowledge that fraud has multiple possible meanings. As I have written elsewhere, *Janus* is different but analogous: claiming judicial primacy over the scope of the implied private right of action under Rule 10b-5. See Donald C. Langevoort, *Lies Without Liars? Janus Capital and Conservative Securities Jurisprudence*, Wash. U. L. Rev. (forthcoming 2013).

³⁹ The misappropriation theory derives from mail and wire fraud law, which initially—under the guise of an “honest services” expectation—turned various forms of fiduciary-like misbehavior into federal crimes. See John C. Coffee, Jr., *From Tort to Crime: Some*

purely relational (and thus constructive) fraud,⁴⁰ and on its face hard to square with the relegation of corporate fiduciary issues to state law that was explicit in the retrenchment decisions of the 1970s, particularly *Santa Fe*.⁴¹ As a great number of commentators have pointed out, the misappropriation theory operates as a property-rights (or corporate secrets) protection regime, which is hardly what the securities laws are about.⁴² Its embrace by the Supreme Court in *United States v. O'Hagan*⁴³ notwithstanding this is best explained the same way as *Chiarella* and *Dirks*—it offers a convenient conclusion to foster the belief that fiduciary cheating undermines market integrity, over which the federal securities laws have expressive dominion. This was enough for the majority to tolerate a major move back in Cary's direction, albeit somewhat constrained by the earlier bargain.⁴⁴ This time, however, there was serious pushback to this from the most conservative members of the Court, for whom the federalism line was particularly sacred.⁴⁵

This is another slice of contested territory where some lower courts (and the SEC) have moved the law beyond its strict insistence on evidence of feigned loyalty and thereby drained some of the moral fervor out of the

Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics, 19 Am. Crim. L. Rev. 117 (1981). For a case connecting misappropriation (and 10b-5 generally) with the mail and wire fraud precedent, see *United States v. Whitman*, 2012 WL 5505080 (S.D.N.Y. 2012). The honest services idea in mail and wire fraud has had a volatile history since that time, and now has a narrower scope in order to avoid excessive vagueness. See *United States v. Skilling*, 130 S.Ct. 2896 (2010).

⁴⁰ See Victor Brudney, *O'Hagan's Problems*, 1997 S. Ct. Rev. 249 (1998).

⁴¹ Two courts of appeals, the Fourth Circuit and the Eighth Circuit, rejected the misappropriation theory on strong federalism grounds. See *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995); *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996).

⁴² E.g., Stephen Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 S.M.U. L. Rev. 1589 (1999). This is underscored by the fact that there cannot be a misappropriation of legitimately acquired information so long as the trader discloses his intent to trade.

⁴³ 521 U.S. 642 (1997).

⁴⁴ See, e.g., Joel Seligman, *A Mature Synthesis: O'Hagan Resolves Insider Trading's Most Vexing Problems*, 23 Del. J. Corp. L. 1 (1998); Elliot Weiss, *United States v. O'Hagan, Pragmatism Returns to the Law of Insider Trading*, 23 J. Corp. L. 395 (1998).

⁴⁵ Justices Thomas (joined by Chief Justice Rehnquist) and Scalia each dissented.

insider trading prohibition. Others have explored this area as well,⁴⁶ so I will be relatively brief here. Sometimes, the source's expectation as to confidentiality is made explicit, as in a code of conduct or insider trading policy statement. Or it could be implicit, as in an unwritten norm understood by those who have been around long enough. Indeed, it should generally be presumed as a matter of law even without an explicit prohibition, since all corporate agents are said to have a duty to act loyally and carefully with respect to their employer's secrets.

I am less interested in how this general expectation is derived than in interpreting its content. Even expressed expectations can vary in how strictly they are to be taken, in terms of exceptions, excuses and the like, and with respect to internal consequences if ignored. The recent case of *SEC v. Obus*,⁴⁷ which we will explore in detail in the next section, is instructive. The insider's employer, GE Capital, may have had a policy against sharing client information, but that would not answer the more subtle question of whether an exception would be tolerated if the person thought it might be helpful to the client or the firm to take a risk as to confidentiality. The same things could be said about brokerage firm policies, which are often at issue.⁴⁸ But we cannot be overly troubled here, because courts do make this a crucial factual question at trial, and permit both sides to have their say about the policy as perceived on the ground, not just in the books.⁴⁹ Assuming the fact-finder gets it right (which may be a

⁴⁶ See Nagy, *supra*; see also Thomas Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 Hastings L.J. 881 (2010); Robert A. Prentice, *Permanently Reviving the Temporary Insider*, 36 J. Corp. L. 343 (2011).

⁴⁷ 693 F.3d 276 (2d Cir. 2012).

⁴⁸ See *United States v. Mahaffy*, 693 F.3d 113 (2d Cir. 2012) (criminal proceeding for conspiracy to commit securities fraud, though not 10b-5 directly). This was also at the heart of the insider trading case against Martha Stewart. See *SEC v. Stewart et al.*, Litig. Rel. 18169, June 4, 2003 (complaint); *SEC v. Stewart*, Litig. Rel. 19794, Aug. 7, 2006 (settlement); on some of the issues here, see Ray Grzeblewski, *Why Martha Stewart Did Not Violate Rule 10b-5: On Tipping, Piggybacking, Front-running and the Fiduciary Duties of Securities Brokers*, 40 Akron L. Rev. (2007); Langevoort, *What Were They Thinking?*, *supra*.

⁴⁹ In *Mahaffy*, *supra*, the court goes at great lengths to consider whether brokerage firm employees faced an explicit or implicit prohibition on passing on "squawk box" information relating to forthcoming client trades that might be front-run by the recipient,

heroic assumption to be sure), liability is reserved for cheaters. The same goes for expectations of loyalty among family and friends, a particularly fertile setting for insider trading enforcement. The seepage in the law here, then, is not so much that we have let go of the fiduciary nexus so much as that we have learned how easy it is as a matter of law to locate that nexus in places outside of conventional principal-agent settings.

The most contested issue here grows out of the SEC's fairly expansive effort to codify crucial aspects of the misappropriation theory in Rule 10b5-2, especially subsection (a). This subsection creates an expectation of abstention from insider trading or tipping from a promise to respect confidentiality. One problem here is that, taken literally, a promise to respect confidentiality says only that the promisor will keep the secret. An insider who transmits an anonymous purchase or sell order of limited size for execution on a stock market does not usually pose a threat to confidentiality, though there are certainly circumstances where the trade would be large or unusual enough that it could.⁵⁰ More important is the disconnect from the "feigned loyalty" that is at the heart of the misappropriation theory. The person who promises to keep a secret may not in any other way be a fiduciary, so that the argument of deception is essentially that a breach of promise is intrinsically fraudulent—which

day traders at another firm. One could reasonably argue that whatever the brokerage firm's expressed policy, the duty of loyalty *to the client* not to undercut its effort to get best execution should be clear as a matter of law. But because the government prosecuted the case simply as one of disloyalty of the employees to their employers, establishing the employers' expectation was presumably essential. For a case where the customer disclaimed an expectation of non-use, see *SEC v. Rorech*, 720 F. Supp.2d 367 (S.D.N.Y. 2010).

⁵⁰ Unless others in the market can infer that this was an insider's trade, it is highly unlikely that there will be any market price reaction resulting from its execution. For an evaluation, see Lauren Cohen et al., *Decoding Inside Information*, 67 J. Fin. 1009 (2012). That said, there will be times when trading does threaten confidentiality, which some see as part of a "property rights" justification for the misappropriation theory. E.g., Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Leg. Stud. 801 (1980); see also *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991)(Winter, J., concurring). One need not assume a threat to believe that the employer (or principal) has a right to exclusive use of the information, of course.

certainly is not true at common law. Some courts have questioned the validity of Rule 10b5-2(a) on these grounds.⁵¹

My sense is that it is all contextual, and that in many circumstances an implied promise of loyalty (i.e., non-use for personal gain) can reasonably be inferred from an explicit promise of confidentiality.⁵² But not always. Consider this hypothetical, which bears some resemblance to (but differs in key respects from) the SEC's on-going case against sports and media entrepreneur Mark Cuban.⁵³ X holds a significant stake in a company, with which he has grown increasingly concerned because of financial missteps. His relationship with company management is starting to fray, and he has thought about selling the block. X receives a phone call from the CEO asking if he will keep some information confidential, and he says he will. The CEO then tells him about a dilutive financing plan, which will probably cause the stock price to drop. X is angry, very much wants to sell, and—without telling the company—does. He suspects that the only reason the CEO called was to try to prevent any sale of the block, which might disrupt the planned transaction by driving down the market price if it occurred prior to consummation.

X promised confidentiality. But in any meaningful sense did he “feign loyalty”? He was increasingly adversarial to the company's management to begin with, and noticeably angry after the fact. Hence,

⁵¹ See *SEC v. Cuban*, 634 F. Supp.2d 713 (N.D. Tex. 2009), rev'd on other grounds, 620 F.3d 551 (5th Cir. 2010)(finding that there were grounds on which to infer a promise not to trade, not just keep the information confidential). In the *Cuban* litigation, a number of distinguished law professors (Allen Ferrell of Harvard, Steve Bainbridge of UCLA, Todd Henderson of Chicago, Jon Macey of Yale and Alan Bromberg of Southern Methodist) filed an amicus brief concluding that the rule is invalid on these grounds. We should distinguish here situations involving promissory fraud, which arise when a person enters into an agreement intending not to perform. See *The Wharf (Holdings) Ltd. v. United Int'l Holdings*, 532 U.S. 588 (2001)(promissory fraud is within the scope of Rule 10b-5, even if breaching a contract is not).

⁵² Certainly trade usage is important here—does the business community in settings like the one at issue normally understand confidentiality to imply non-use as well. And again, the issue would be different if the promise were designed to gain access to the information, where the promisor intended to breach.

⁵³ See note [51] *supra*. Cuban denies making such a promise.

loyalty could not be much of a reasonable expectation on the CEO's part, exceedingly hard to infer simply from a simple promise of secrecy. That would be all the more so if X was right in his suspicion as to the CEO's motives—trickery can hardly lead to a reasonable expectation of fidelity.

III. RECKLESS TIPPING

A. Tippers

Ever since *Cady Roberts*, insider trading litigation has wrestled with the “tipping” problem: many people who trade on inside information are not themselves insiders, but received the information from (and are thus enabled by) someone who is. *Cady Roberts* involved what may have been an innocent situation, because the insider—a director—shared the information with his brokerage firm colleague apparently believing that it had been released publicly, though it actually had not. Most tips are more venal, of course, where there is no doubt that the insider desires that the recipient be enriched by the trading opportunity, passing on the information precisely for that reason.

Cary finessed this issue by focusing on the recipient's awareness that the information was still non-public and the fact that both “tipper” and recipient worked for the same brokerage firm, which was the principal respondent in the administrative proceeding. Over the first two decades of insider trading law, the law continued to follow this pattern; the stress was less on formal status than access to an unfair informational advantage, and few could doubt that someone with a friend or colleague on the inside

willing to share secrets was as privileged—and in a position to exploit the information unfairly—as the insider himself.⁵⁴

The retrenchment in *Chiarella* upset this, however, by making fiduciary status the key to finding the necessary deception, because of the presumed affirmative duty of disclosure fiduciaries have when transaction with their beneficiaries. That refocused attention on the insider. If being a fiduciary is essential to insider trading liability, what of tippees? The Supreme Court anticipated this in a footnote, suggesting that there might be something in the law of civil conspiracy that could cause the tippee to take on the insider's fiduciary duties and restrictions.⁵⁵ A few years later, the Court addressed this squarely in the *Dirks* case.⁵⁶ The opinion is generally read to say that the insider (tipper) is liable if but only if he breaches a fiduciary duty for personal benefit by passing on the information. This personal benefit can come in a variety of forms: pecuniary, reputational, or simply making a gift of the information to a family member or friend. The recipient (direct or indirect tippee) is liable as a co-venturer if he knew or had reason to know of the breach.

The *Dirks* test seems to speak to the state of mind of both tipper and tippee, and thus be about scienter. But the Court never says that, and notice the incongruity with post-*Hochfelder* jurisprudence. The insider's purpose and motivation appears crucial, whereas in the normal 10b-5 case the standard is knowledge or recklessness, neither of which makes purpose or motivation important. To me, the Court was staking out a unique state of mind standard here, an illustration of the sui generis nature of insider trading law stressed earlier. Indeed, as many courts and commentators have observed, the Court's use of "know or should know" in crafting a tippee liability standard seems to fly directly in the face of *Hochfelder*. That

⁵⁴ See LANGEVOORT, *supra*, §4:2.

⁵⁵ 445 U.S. at 230 n. 12.

⁵⁶ 463 U.S. 646 (1983).

caused some to conclude that the Court had made a careless mistake in exposition, and really meant to say knowledge or recklessness.⁵⁷

We will come back to tippee liability shortly. I have long assumed (and continue to believe) that *Dirks* is describing the essence of a tip as a communication *deliberately intended* to benefit both tipper and tippee by enabling the latter's trading. It is thus a form of conscious fiduciary disloyalty.⁵⁸ This is underscored when the Court says that this rule is designed to prevent insiders from doing indirectly (gaining a personal benefit through someone else's trading) what they cannot do directly under *Chiarella* (benefit by trading for their own account). If that is so, then by all accounts there is no such thing as an innocent, or even negligent, tip. The insider in *Cady Roberts* would not have been breaching a fiduciary duty to the issuer by passing on to colleagues what had already been made public. Carelessly talking too loudly with colleagues on a train, or mindlessly leaving a briefcase open for others to see would not be a violation even if it facilitates trading. The element of deliberate disloyalty is simply not there.

But can there be a reckless tip? Recently, in *SEC v. Obus*,⁵⁹ the Second Circuit said yes. There, an analyst for GE Capital, Strickland, was helping develop the financing of a possible acquisition of a company called SunSource. Strickland called a friend who worked at a hedge fund that held a large equity stake in SunSource. What was said in that conversation was in controversy, but according to the SEC, included the fact that the client was planning the acquisition. The hedge fund later acquired more SunSource stock.

⁵⁷ See, e.g., *SEC v. Falbo*, 14 F. Supp.2d 508 (S.D.N.Y. 1998); see LANGEVOORT, *supra*, §4:9; Buell, *supra*.

⁵⁸ See LANGEVOORT, *supra*, §4:6 & n.2; see also DONNA NAGY & RICHARD PAINTER, SELECTIVE DISCLOSURE BY FEDERAL OFFICIALS AND THE CASE FOR AN FGD (FAIRER GOVERNMENT DISCLOSURE) REGIME (unpublished manuscript, Sept. 2012) at 22-24. A particularly clear endorsement of this is *SEC v. Yun*, 327 F.3d 1263, 1275 (11th Cir. 2003), citing language from *Dirks* itself.

⁵⁹ 693 F.3d 276 (2d Cir. 2012).

On the surface, the SEC's argument is conventional. If Strickland's motivation for contacting his friend was to do the friend a favor, then that would satisfy *Dirks* as applied under the misappropriation theory so long as GE Capital had an expectation that the information would not be so used. Reversing a grant of summary judgment by the trial court, the Second Circuit found these issues to involve triable factual questions, which is not all that surprising a result.⁶⁰

The defendants' argument was that the phone call was meant to serve the client's interest, which would preclude a finding of misappropriation. One can see various ways in which this would be true: Strickland might have been trying to get helpful information about SunSource from the hedge fund manager, and/or trying to use his connection to curry favor with a large shareholder that could be used to smooth along the acquisition. That, however, simply makes clear the factual nature of the inquiry, and would not necessarily make the case especially interesting as a matter of law. It would show that *Dirks*' avowed effort to use the insider's motivation as a bright-line way of separating wrongful from legitimate trading is an illusion, but by now that point is fairly well understood. Human motivations are endlessly complex and indeterminate.⁶¹

Instead, what makes *Obus* interesting is the court's suggestion that even if Strickland was not deliberately tipping his friend for personal gain, both could still be liable if Strickland acted recklessly in communicating the

⁶⁰ See note [47] *supra*. We should note here a lingering question about whether the misappropriation theory even has room for tipper-tippee liability given how it was articulated in *O'Hagan*, where in addressing how the "in connection with" requirement was satisfied noted that the misappropriation and trading "coincide." That is not so in tipping cases, however, when there may be some time between the tip and the trade. See Donna Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 Ohio St. L.J. 1223 (1998). Subsequent courts have uniformly rejected a strict co-incidence standard, finding a foreseeable causal relationship sufficient. See, e.g., *United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001). It should be noted, however, that the two dissenting justices (Thomas and Scalia) on the *O'Hagan* court, who pushed hard on this issue, remain and would no doubt be skeptical of any approach that attenuates the "in connection with" requirement.

⁶¹ See Langevoort, *What Were They Thinking?*, *supra*.

information in violation of GE Capital's expectations.⁶² Here we see a court treating insider trading as part of a larger fabric of Rule 10b-5, invoking the scienter standard of an extreme departure from ordinary care without even the subjective awareness add-on that most other courts demand.⁶³

But how does this square with *Dirks*' insistence that the insider's motivation in tipping be to seek a personal benefit? The case law background here is circuitous. For some time the SEC had been contending that the *Dirks* personal benefit test simply does not apply in misappropriation cases—only cases brought under the classical theory—and a few district courts had agreed.⁶⁴ Moreover, the Second Circuit had in two high-visibility cases, *United States v. Libera*⁶⁵ and *United States v. Falcone*,⁶⁶ indicated that a misappropriation might be found where it was not even clear that the insider meant the conveyance of secret information as a tip to facilitate stock trading, as opposed to some other way of benefiting from the information. All this was suggesting that there was ample room for misappropriation to develop as a separate and distinct concept of “stolen property” fraud, not just a different way of looking at to whom the fiduciary duty is owed. The *Obus* court does not follow along

⁶² This is more expansive than the language in another recent case would suggest, where in dicta the Second Circuit said in prosecuting a tipper, the government must prove that “the tipper conveyed material nonpublic information to his ‘tippee’ with the understanding that it would be used for securities trading purposes.” *United States v. Gansman*, 657 F.2d 85, 92 (2d Cir. 2011). In *Obus*, the court gives a “hypothetical” example of a person on a train who knowingly holds a sensitive telephone conversation in the presence of a friend who is a day trader, so that it is highly likely the friend will be tempted to trade based on what he hears. 693 F.3d at 287. For examples of such cases at the district court level, see *SEC v. Berrettini*, 2012 WL 55579993 (N.D. Ill. 2012); *SEC v. Keung*, 2010 WL 3026618 (S.D.N.Y. 2010); *SEC v. Aragon Capital Mgt. LLC*, 2009 WL 4277244 (S.D.N.Y. 2009)(insider cannot “turn a blind eye” to the likelihood of trading).

⁶³ See notes [26-27] *supra*.

⁶⁴ See *SEC v. Musella*, 748 F. Supp.2d 1028 (S.D.N.Y. 1989); for dicta in support of this, see *SEC v. Sargent*, 229 F.3d 68 (1st Cir. 2000). On the other hand, this view was squarely rejected in *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003). See David Cohen, *Old Rule, New Theory: Revisiting the Personal Benefit Requirement for Tipper/Tippee Liability Under the Misappropriation Theory*, 47 B.C. L. Rev. 547 (2006).

⁶⁵ 989 F.2d 596 (2d Cir. 1993).

⁶⁶ 257 F.3d 226 (2d Cir. 2001).

these lines, however, and in fact says that the *Dirks* test does apply in misappropriation cases.

We should be careful here in parsing out the court's dicta, which the first lower court to read it found "Delphic."⁶⁷ One possible reading harks back to one of the misappropriation cases just mentioned, *United States v. Falcone*. There a warehouse employee leaked advance copies of *Business Week* in return for a substantial payoff. The defendant's argument on the insider trading count was that the leak was not necessarily for securities trading—he did not know why the recipient wanted an early look at the magazine. The Second Circuit dismissed this argument, in language that suggests (though it does not use the word) recklessness. Given the court's inference that someone in defendant's position would have realized at least a strong likelihood that insider trading was the recipient's plan, this would seem to fit the definition.⁶⁸

In *Falcone*, there was no doubt that the "insider's" breach of fiduciary duty was both clear and self-serving. Thus, the ruling does not press all that hard on the Cary-Powell compromise. *Obus*, on the other hand, seems to invite the SEC to make a more aggressive kind of claim. In fact, it says explicitly that *Dirks*' personal benefit requirement is not part of a scienter inquiry.⁶⁹ What the court seems to do here is disconnect benefit from intention, rendering intention superfluous. If Strickland acted in a way that was an extreme departure for ordinary care—but short of deliberately—liability could nonetheless follow for both tipper and tippee so long as there

⁶⁷ See *United States v. Whitman*, 2012 WL 5505080 n. 6 (S.D.N.Y. 2012).

⁶⁸ As a matter of law, *Falcone* was mainly addressing the "in connection with" requirement under Rule 10b-5 in light of *O'Hagan's* holding that that test is satisfied when the misappropriation "coincides" with a purchase or sale. *Falcone* gives a liberal reading to this, saying that the Court's use of coincidence was not meant to eliminate tipping liability under the misappropriation theory, which is what would happen if the only misappropriation that could be actionable would be the act of trading itself. See Nagy, *Reframing*, *supra*.

⁶⁹ 693 F.3d at 286. The court says that tipper scienter focuses on three things: the fact of the tip, the material nonpublic nature of the information, and the breach of a duty of confidentiality. The court then says that each of these may be met via a showing of recklessness.

was *in fact* a benefit to the tipper.⁷⁰ The court justified this by pointing to language in *Dirks* that suggests that the personal benefit standard is meant as an “objective” test, rather than being about subjective motivation. Hence a tip could conceivably occur without any actual awareness on the part of the insider that he was acting wrongfully (feigning fidelity) vis-à-vis the source of the information.

Dirks’ reference to an objective standard is admittedly confusing,⁷¹ but I have always read it simply as explanation for why the personal benefit standard helps the tippee know where he stands (i.e., a tippee should be able to tell whether the information is being conveyed selfishly), and therefore should not chill legitimate investment research or trading. The question remains one of the insider’s motivation, however. In that sense, I find *Obus*’ styling of the law of reckless tipping at least potentially unsettling. In a casebook on securities regulation that I co-author, there has long been a hypothetical problem in which a new associate at a law firm goes home for Thanksgiving and over dinner tells her parents about some projects on which she is working, including a yet unannounced merger.⁷² Her father buys stock in the acquiree company shortly thereafter. Part of the problem is meant to ask whether the father is liable as a misappropriator (probably yes under the intra-family presumption in Rule 10b5-2(b)(3)), but then the question arises as to the young associate herself. Is she a tipper? I have always thought the right answer is no, so long as the judge or jury does not find that she meant to enrich her father with the information by tipping him.

⁷⁰ The language in *Obus* is somewhat ambiguous as to precisely what work recklessness is supposed to be doing in the case against Strickland. See 693 F.3d at 291 (“And it is sufficient for a jury to conclude that Strickland intentionally or recklessly revealed material non-public information to Black, knowing that he was making a gift of information that Black was likely to use for securities trading purposes”). That could be read to merge knowledge of the benefit with recklessness. But given the court’s analysis earlier in the opinion, especially in disconnecting benefit from scienter, this would not necessarily follow.

⁷¹ Adam Pritchard suggests based on historical research that the personal benefit standard was added to the *Dirks* opinion at the behest of Justice O’Connor, who thought that breach of duty by itself was too broad for the courtroom—thus the introduction of a more objective standard based on benefit. Pritchard, *supra*.

⁷² See COX ET AL., *supra*, at 906 (problem 14-4).

After *Obus*, however, the answer might be different if the fact-finder considers what she did reckless (which it may or may not be, to be sure). If that is right, *Obus* shifts the law—and so changes the risks—having to do with discussing secrets in a variety of business and non-business settings.⁷³

That *Obus* may be shifting the law in this way is not necessarily a criticism, of course. Corporate secrets are important, and recklessness is bad, so sanctioning Strickland as a tipper may seem amply justifiable. Plus it provides a safety valve should a disingenuous defense of mindlessness sway the jury. So long as the sanctions that would come from finding him a non-deliberate tipper are proportionate to this lesser level of culpability, and civil insider trading sanctions are certainly flexible in this regard, there is something to be said for this expansionist approach to liability. The analogy to the possession versus use issue here is noteworthy. The argument for possession alone (or simple awareness) is that it makes prosecution and enforcement easier and matches up more cleanly with our general understanding of scienter. So, too, with reckless tipping, and it is thus not surprising that the Second Circuit was earliest and most clearly on board with the possession test, well before Rule 10b5-1,⁷⁴ and that *Obus* cites that authority with approval.

The concern is the same as well. A use standard demands that the conduct stay close to the core concern that animated the law of insider trading in the first place and justifies the abandonment of any serious investor deception requirement. If the SEC or a prosecutor cannot persuade a judge or jury that there was true venality of the sort we associate with greedy opportunism by the privileged in core insider trading cases, marketplace integrity is not dangerously threatened. Remember, no

⁷³ Some indication that the Commission might not be pushing this idea too aggressively can be found in a proceeding where a young associate at a law firm talked too openly about a project she was working on with a close friend, who was an investment analyst at a financial services firm. The Commission proceeded against the remote tippees, but not (so far) the young lawyer. See SEC v. Conradt et al., Litigation Release No. 22581, 2012 WL 6705847 (S.D.N.Y., Dec. 26, 2012); Brian Baxter, *Associate's Failure to Keep Secrets a Cautionary Tale for Young Lawyers*, Am. Law Daily, Nov. 30, 2012.

⁷⁴ See note [33] *supra*.

contemporaneous traders were harmed by relying on what Strickland or his tippees did.⁷⁵ As to the source (GE Capital), that takes us to another important part of the case. In holding that whether GE Capital's reasonable expectations were frustrated is a disputed question of fact to be resolved at trial, the court had to address the fact that GE Capital did investigate and chose not to sanction Strickland, suggesting that it did not feel particularly deceived by his behavior. The court dismisses this as an argument to be reserved for trial, and notes that GE Capital's own interests and the public interest in market integrity are different. True, but then we come back to our conception of how insider trading and market integrity relate, and whether this conduct bears enough family resemblance to the core. If greediness is an essential feature of marketplace abuse, we may have crossed a line here.

B. Tippee Scienter

The "knows or should know" standard in *Dirks* has always been hard to explain, especially if one want to try to fit it within a theory of strong moral culpability. The effort by some courts to use recklessness here instead was revisionism in that direction.⁷⁶ At the very least, my impression has been that such a broad standard could only have been intended by the Court on the assumption that liability arises only when the tipper conveys the information *as* a tip, so that the recipient understands that the information is to enable profitable trading. So long as that is clear to the tippee, then a reason to know formulation as to breach is not unfair.

Obus goes on to address (maybe alter) the law relating to tippee scienter, too. The court says that *Dirks*' "knows or should know" language

⁷⁵ The hedge fund received an offer of a large block, and accepted it. To be sure, had the hedge fund gone looking for a large number of shares of a relatively thinly traded stock with an aggressive bid, it might have pulled sellers into the market.

⁷⁶ See note [57] *supra*.

was no mistake, and that—taking in to account the tippee’s own knowledge and sophistication—it is enough to show that he had reason to suspect that the information was acquired through some impropriety by the insider.⁷⁷ That, of course, further disconnects the legal standard from one of strong moral culpability, and makes the suspiciousness of the information’s source sufficient to trigger the tippee’s duty to abstain from trading. Given that the tippee need not have awareness of the facts relating to the breach and benefit, the message here is that recipients of valuable information should assume that it is tainted, and not trade unless they are fairly sure it is legitimately theirs to take advantage of.

To anyone entirely committed to aggressive insider trading enforcement, this is surely an appealing standard. The only serious scienter element here is awareness that the information is both material and nonpublic. Enforcers can go after any recipient who understood that what they received was valuable and would not be able to establish a reasonable belief that they were entitled to the informational advantage. I am assuming here that tippees still cannot be held liable unless their tipper is liable under that separate *Dirks* standard, so that enforcers will have to show breach and personal benefit on the tipper’s part in order to get the tippee. *Dirks* seems to say this fairly clearly, though there is at least one strange court of appeals decision from a few years ago, *United States v. Evans*,⁷⁸ that can be read to hold otherwise. But with the expanded scope for tipper liability that *Obus* signals, this is somewhat cold comfort.⁷⁹

⁷⁷ 693 F.3d at 288.

⁷⁸ 486 F.3d 315 (7th Cir. 2007). This case dealt with whether a tippee could be convicted after his tipper was acquitted on the same charges, and in saying yes, the court seems to suggest that the first part of the *Dirks* test is not essential to tippee liability. For criticism, see LANGEVOORT, *supra*, §4:12 & n.8 (stretching the logic of *Dirks* “beyond its breaking point”); Nagy, *supra*, at 1346-47.

⁷⁹ *Obus* was not a criminal case, and there is good authority, at least in the Second Circuit, for believing that the standard of proof for criminal insider trading would be higher as to a tippee. See *United States v. Cassese*, 428 F.3d 92 (2d Cir. 2005); *United States v. Whitman*, *supra* (discussing post-*Obus* criminal standard for tipper-tippee liability). So we should not assume that its teachings necessarily lead to a greater risk of criminal prosecution.

Scienter as to non-publicness, in particular, can be important.⁸⁰ Take the SEC's settled case from a few years ago against Martha Stewart,⁸¹ on which, in hindsight, *Obus* is quite instructive. Stewart was aware that a biopharmaceutical company in which she was heavily invested was awaiting important news about its key product from the FDA. She received a phone call from her stockbroker, who (she knew) was also the broker for the company's principal insiders, essentially saying that the stock's price was dropping and the insiders were selling. It turns out that the FDA had in fact delivered bad news, which the company had not yet disclosed, though this fact itself was not communicated to her. So styled, the case would require the SEC to show that the broker misappropriated information from the insiders and/or the brokerage firm in passing on what he did to Stewart (i.e., he was the tipper). And she (the tippee) would have to know of its material, nonpublic nature, and have reason to know that the disclosure to her was wrongful. Most discussion of the case has focused on the wrongfulness issue, and *Obus* suggests that the awareness standard would not be an exacting one as to that. But if the knowledge of materiality and non-publicness is more strict, that might actually have been her best defense: especially after a phone call that began with the fact that the stock price was already dropping, her quick impression might well be that word of the FDA's decision had gotten out to the market, so that the information about the insiders' selling might not have been so sensitive. We could call that a careless inference, maybe even extreme, but it is quite possible that her mind never really focused on the precise content of the information.

⁸⁰ On the connection between recklessness and materiality, see Allan Horwich, *An Inquiry into the Perception of Materiality as an Element of Scienter Under Rule 10b-5*, 67 Bus. Law. 1 (2011); see also Langevoort, *supra* §5:6.

⁸¹ See note [48] *supra*.

IV. DECEPTION WITHOUT A FIDUCIARY BREACH

For some time, we have known of one big conceptual gap in the law of insider trading under the contemporary doctrinal framework: Rule 10b-5 does not reach the trading based on the simple theft of information.⁸² Various forms of industrial espionage can target sensitive corporate secrets, and use the fruits to trade. Of course theft is independently criminal and tortious, so that our legal system hardly tolerates this kind of abuse. It is simply that we fail to include it within the insider trading regime.

This is because theft is typically neither a breach of fiduciary duty nor fraudulent. It can be, of course—a fiduciary can steal—and to some extent the misappropriation theory is simply based on the constructive fraud of the fiduciary’s conversion of the source’s information. But building insider trading theory around the fiduciary principle meant that non-fiduciary conversion or misappropriation was left out. This is what led Chief Justice Burger to dissent in *Chiarella*. He thought the duty to abstain or disclose should extend to situations where the trader had misappropriated the information even in the absence of any fiduciary duty owed to either marketplace counterparties or the information’s source.⁸³

There are, however, situations where the theft of information by a non-fiduciary could involve some element of deception. What of this? That issue arose in *SEC v. Dorozhko*,⁸⁴ a hacking case. Defendants were foreign traders who hacked into a server that facilitated the public

⁸² See LANGEVOORT, *supra*, §6:13; but see Robert Steinbuch, *Mere Thieves*, 67 Md. L. Rev. 570 (2007).

⁸³ The Court in *Chiarella* did not address Burger’s approach because it was not properly charged to the jury, and so for a time it had some potential. However, the version of the misappropriation theory that the Second Circuit embraced was instead the one we have come to understand as the “fraud on the source” theory, endorsed in *O’Hagan*. Many have argued that the law of insider trading would have been better off had the Burger theory been followed. See, e.g., Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella’s Past, Central Bank’s Future*, 20 Del. J. Corp. L. 865 (1995); Nagy, *Demise*, *supra*.

⁸⁴ 574 F.3d 42 (2d Cir. 2009).

disclosure of corporate news, and so at any given time contained not-yet-released material information. These hackers could hardly be deemed fiduciaries, owing no duty to other marketplace traders and feigning no loyalty to anyone. Nonetheless, the Second Circuit held they could be said to violate Rule 10b-5 by reverting to the plain text of Rule 10b-5 rather than either the classical or misappropriation theories. To the extent (which would be determined on remand) that hacking involves tricking the host system into treating access as authorized, there could well be deception. And any such deception designed explicitly for gaining a trading advantage would be in connection with the purchase or sale of a security.

While this seems to be an example of what I have criticized earlier—the use of 10b-5 tools that fail to recognize that the deception in insider trading is largely fictional—it is not. If one accepts the court’s characterization of hacking, we have real deception here, and do not need to resort to constructive fraud. Rather this poses the opposite question: is there any reason to consider the two fiduciary-based theories exclusive statements of insider trading’s scope? The Second Circuit could think of no good reason to, and neither can I.⁸⁵ The classical and misappropriation theories are simply two inventive compromise solutions to the deception puzzle, embraced because they do what courts have thought to be important work in sustaining the expressive campaign against insider trading. To me, this limited third way targets conduct that is as disturbing as any fiduciary breach. We are by no means bleeding the insider trading prohibition of its moralism here.

The remaining awkwardness is that this still leaves plain theft uncovered, but that does not seem to be a good justification for not reaching

⁸⁵ The argument that finding hacking to be the basis for insider trading ignores the fiduciary breach requirement of *Chiarella* and *O’Hagan* is precisely the reason given by the Fourth and Eighth Circuits for why the misappropriation theory was invalid (see note [41] supra): it ignored *Chiarella*’s insistence that we look for a fiduciary duty owed to other marketplace traders. But *O’Hagan* held that nothing in *Chiarella* was meant to say that it was setting the exclusive test for insider trading liability. So, too, with *Dorozhko*’s theory of deception. For further analysis, see Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses and Best Practices for Ensuring Compliance*, 8 N.Y.U. J. L. & Bus. 151, 158-61 (2011).

what we can within textualist limits. We can think up many interesting hypotheticals to tease this out. If one knew that a New York City bicycle courier was carrying papers about a secret transaction, simply knocking him down while he was rounding a corner and running away with the bag would not violate Rule 10b-5. But luring him into a dark alley by falsely suggesting a short cut might. Or consider the difference between breaking into an executive's house and finding the office and lying to get access to a part of the house ("I need to find a bathroom") that would allow undetected access to the office as well.⁸⁶ These are "fine distinctions," to be sure, but the inevitable result of how we have constructed the law of insider trading.

V. CONCLUSION

With *Cady Roberts*, Cary set in motion a conversation about insider trading as fraud among those who make this law: the courts and the SEC. I have suggested that we think in terms of a compromise that occurred when Justice Powell and the Supreme Court first tried to take control of the doctrine, accepting insider trading as deception but confining the scope of liability for this kind of constructive fraud to those who commit or participate in a fiduciary-like breach. It is instructive to imagine an actual conversation about this between Cary and Powell, their total disagreement on federalism and judicial (and administrative) restraint bridged by their shared disdain for fiduciary misbehavior common to insider trading. In this imaginary negotiation, I suspect Cary got more than he gave up, especially in light of the later endorsement of the misappropriation theory.

There is another conversation that has gone on, however, largely between the SEC and criminal prosecutors and the New York-based judges in the Second Circuit. That insider trading is fraudulent and harmful is taken for granted, thereby justifying an approach that looks aggressively for

⁸⁶ See *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006)(wife "tricks" husband into revealing inside information).

ways of penalizing those who know or suspect that they have a trading advantage derived from information that does not belong to them. *Texas Gulf Sulphur* was the starting point for this conversation, and the contemporary cases like *Obus* and *Dorozhko* show that it remains a fruitful one.

By and large, I think that the Second Circuit judges have done well in preserving and extending Cary's original ideas as against the competing impulses of federalism and restraint. Generally, I favor aggressive insider trading regulation because insider trading should be seen as market abuse,⁸⁷ whether or not it is meaningfully described as deception. As Cary said, neither fine distinctions nor rigid classifications should constrain such an expressive form of law. But the market abuse caused by insider trading is mainly reputational, and so—especially in a time when the penalties against insider trading can be so harsh compared to other kinds of securities fraud—maybe we should be reserving the category for conduct that is plainly greedy and abusive. This is the aspect of the Cary-Powell bargain that maybe we want to hold onto a bit more carefully. That one can make an argument that something is insider trading does not always mean that one should.

⁸⁷ This is the phrase used in Europe, where insider trading prohibitions have been codified based on a policy of market protection, not limited to fraud. See Guido Ferrarini, *The European Market Abuse Directive*, 41 Common Mkt. L. Rev. 711 (2004).